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## ROUTING AND RECORD SHEET

SUBJECT: (Optional)

14 April Joint EPC/DPC Meeting on Energy Security

FROM:

Deane E. Hoffmann  
NIO for Economics

EXTENSION

NO.

NIC 01624-87

DATE

10 April 1987

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TO: (Officer designation, room number, and building)

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COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)

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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 01624-87

10 April 1987

MEMORANDUM FOR: Acting Director of Central Intelligence

FROM: Deane E. Hoffmann  
National Intelligence Officer for Economics

SUBJECT: 14 April Joint EPC/DPC on Energy Security

1. Action. Deputy Secretary Martin told me he would like you to speak on the security aspects of reliance on Persian Gulf oil at the EPC/DPC. He plans to call you to give more detail on how he would like the security presentation to fit the overall meeting. Talking points on energy security and some background on the published, unclassified energy security study are attached.

2. The key point is that, while we take for granted that the Persian Gulf is a hot spot, we also take for granted the existence of moderate, friendly Arab regimes on the Arabian Peninsula. We can't forecast a violent turnover as a probability over the next 10 to 12 years, but we must remember that conditions are ripe for problems and that the result could be as detrimental to our interests in many ways as the fallout from the Iranian revolution.

3. Background. Roughly a year ago the President tasked the Department of Energy to prepare a study on energy security and policy recommendations. Bill Martin took charge of the effort and played the role of lead analyst. At his request, OGI participated in the study and provided much of the analysis relating to future reliance on oil. The bottom line of the study is that our reliance on Persian Gulf oil will increase in the 1990's; the rate of increase will depend largely on prices between now and then. The lower the path of oil prices, the greater the reliance on Gulf oil in the 1990s.

4. The unclassified study was discussed at an EPC/DPC meeting on 20 March. The EPC/DPC was in general agreement that:

- A better definition of energy security as it relates to the policy alternatives was needed (this was provided by OGI, Tab C);

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SUBJECT: 14 April Joint EPC/DPC Meeting on Energy Security

- Import tariffs and domestic energy taxes aimed at reducing reliance on foreign oil are too expensive;
- A more rapid rate of additions to the strategic petroleum reserve (SPRO) is the most viable option; and
- There should be some sort of assistance to the domestic industry to improve domestic production.

Options are constrained by two key factors--they must (a) be "revenue neutral;" and (b) not include new taxes.

5. Even the two leading options--additions to SPRO and aid to industry-- caused substantial debate. While aid to the domestic oil industry has obvious political advantages, it would increase production now but not help energy security in the 90's. Further, there is reluctance to begin discussions of tax breaks so quickly after enacting tax reform. The SPRO fill was clearly the prime option, but even at current oil prices it is extremely expensive. The goal is for a SPRO of 750 million barrels by the mid- to late 1990's, as compared to the current level of 516 million. The options relate to the rate of fill.

6. Because of diverse interests--the free market, the oil industry, and the budget--the meeting should be lively. You should be aware that OMB is suggesting (as a red herring) that additions to US oil reserves be made contingent on other countries making similar efforts. Nearly everyone at the table will understand that other countries will not follow suit.

7. Because the draft background and options package is being revised significantly on Friday, I am not including it and will pass on the final version when it arrives Monday.

  
Deane E. Hoffmann

Attachments:

- |  |      |
|--|------|
| A. Talking Points on Instability and Oil Security in the Persian Gulf, NESAs paper, 9 April [redacted] | 25X1 |
| B. Background Paper on DOE Energy Security Study, OGI paper, 9 April [redacted]                        | 25X1 |
| C. Definition of Energy Security and US Interests, OGI paper, 9 April [redacted]                       | 25X1 |
| D. Arabian Peninsula: Prospects for Political Change, NESAs NESR 15 August 1986 [redacted]             | 25X1 |

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**THE WHITE HOUSE**  
**WASHINGTON**

**DOMESTIC POLICY COUNCIL AND ECONOMIC POLICY COUNCIL  
JOINT MEETING**

**Tuesday, April 14, 1987**

**11:00 a.m.**

**Roosevelt Room**

**AGENDA**

- 1. Energy Security -- Secretary Herrington**

**SECRET**THIS DOCUMENT CONTAINS NO  
No. 33 of 55 Copies, Series A**MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL AND DOMESTIC POLICY COUNCIL**

**ISSUE:** Do energy trends pose a national security threat? If so, are current policies adequate? If not, what new initiatives are required?

**BACKGROUND**

In September 1986 the President directed the Secretary of Energy to conduct an interagency review of the energy security of the U.S. The Congress affirmed this directive in the FY 1987 Budget Reconciliation legislation and asked the President to submit views on the impact of oil import levels on U.S. energy security.

In its study, completed in March 1987, DOE drew several conclusions about the world oil situation and possible actions that the U.S. might take. To assist the President in formulating a response to the Congressional request, the study's conclusions have been reviewed by the Domestic Policy Council Working Group on Energy, Natural Resources and Environment. This paper contains information developed by the Working Group, including options for consideration by the President.

**World Situation**

World oil prices suddenly collapsed in 1986, falling by more than 50% from \$27 in early 1986 to about \$10 a barrel at mid-year, before rebounding to \$18 a barrel in early 1987. Oil prices, however, are under pressure and the outlook remains uncertain.

Lower oil prices have brought significant benefits to the national economy and to consumers. Lower prices have led to the lowest inflation level in 25 years, which in turn, contributed to lower interest rates. Unemployment is at its lowest level in seven years. And lower oil prices have favored individual energy-users such as the average car owner, who saves about \$165 a year through lower gasoline bills.

Despite the overall benefits to the economy, the oil industry has been badly hurt. The sudden collapse in prices shocked the domestic oil and gas industry. Oil company budgets were slashed, and 300,000 jobs were lost in 1986. Job losses represent 26% of the oil and gas workforce. U.S. oil production fell by 800,000 barrels per day in 1986, with an additional loss of 400,000 or more expected in 1987. To date, U.S. oil production has fallen by nearly one million barrels per day (includes natural gas liquids).

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Although projections are inherently uncertain, a range of oil price projections developed for the Energy Security Study indicates that if present trends persist, U.S. net oil imports will rise from 33% to 37-55% of U.S. consumption by 1990-1995 (6 to 8 million barrels per day in 1990 and 8 to 10 MMBD in 1995). Two-thirds of this rise in oil imports is a result of the projected 2-3.4 MMBD decline in U.S. oil production and the remainder is due to rising consumption. The market share for OPEC countries (whose production comes primarily from the Persian Gulf) would rise from 40% to 45-60% by the early 1990's -- comparable to OPEC's market share in the 1970's.

Growing reliance on oil from unstable Persian Gulf suppliers increases the likelihood of oil supply disruptions. Disruptions in the 1970's contributed to the largest economic recession since the 1930's. The effects of the disruptions were exacerbated by the imposition of price and allocation controls. Today we are in far better shape to respond to a supply disruption that might occur in the 1990's than we were in the 1970's. Emergency stocks worldwide, over 900 million barrels including the SPR, will be sufficient to respond to net reductions in supply twice as large as those of the 1970's.

A very large disruption in the 1990's, although unlikely, is possible. It could disrupt more than 5 million barrels per day of oil (even after accounting for increased production and stock drawdown in non-disrupted regions). Analysis indicates that if such a large scale disruption occurred (which would be two to three times as large as historical size disruptions) and lasted for 6 months, oil prices might rise by \$18 to \$50 per barrel (even with a rapid drawdown of the SPR). As a result of higher prices, even with a rapid drawdown of the SPR, U.S. GNP could drop temporarily by 1 to 2 percent or \$40 to \$110 billion below where it would otherwise have been. There also could be a transfer of wealth from the U.S. to oil-producing countries due to higher oil prices -- similar economic losses would be felt by other net oil-importing nations.

Such disruptions would again cause economic dislocations. Rapid and effective response by the Government, including SPR drawdown and avoidance of ill-conceived policies such as price and allocation controls, will help prevent the losses in economic performance that occurred in the 1970's. A panicked reaction could jeopardize the gains made by the Administration in decontrolling oil prices and deregulating the oil industry.

#### General Working Group Recommendations

In response to the current world situation, the Working Group recommends that we take steps to protect ourselves from potential supply interruptions and increase our energy

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security. These steps should include: increasing our domestic stockpiles, which we can draw down in the event of a supply interruption; maintaining a strong domestic oil industry; expanding the availability of our oil and gas resources; and promoting among our allies the importance of increasing their stockpiles. Our response to potential supply interruptions must be an allied response. The Working Group unanimously concurs with the DOE conclusion that the cost of an oil import fee outweighs the benefits.

### Present Programs and Agreed Policies

The Administration's basic energy policy is to rely primarily on energy markets, supplemented by the SPR. The Administration is also concerned about undue reliance upon a single source of supply or a single set of suppliers. The importance of energy to our economic competitiveness and national security is well recognized, and during the first six years of this Administration major gains were achieved in strengthening our foundation for long-term energy security:

- o Decontrolled oil prices in 1981 which allowed domestic production to increase through 1985 and continue to restrain demand.
- o Reduced the Economic Regulatory Administration workforce from 2000 to 200.
- o Significantly cut-back spending on ineffective energy programs such as synthetic fuels.
- o Preserved treatment of intangible drilling costs in the tax reform bill and retained the full-cost accounting provisions.
- o Filled the Strategic Petroleum Reserve to more than half a billion barrels and committed to a 750 million barrel goal.
- o Reestablished the 5-year OCS leasing program and reduced the minimum bid for certain offshore leases.
- o Increased the budget for clean coal to \$2.5 billion over the next 5 years and reestablished a Federal coal leasing program.
- o Lifted foreign policy controls on the export of petroleum equipment and technology.

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- o Encouraged allied stockbuild and improved West European natural gas security through the conclusion of the Troll Sleipner project.
- o Continued gains in energy conservation from individual actions, with consumers making their own decisions to use energy more efficiently.

New proposals supported by the Administration need to be pursued vigorously and include:

- o Comprehensive natural gas decontrol including wellhead price decontrol, mandatory contract carriage and repeal of demand restraint.
- o Repeal of the Windfall Profit Tax.
- o Continue to improve access to OCS and federal lands and proceed administratively on leasing and royalty issues including reducing royalties for certain coal leases; initiating congressional procedure for OCS moratoria similar to Gramm-Rudman-Hollings; providing that Wilderness Study Areas, properly recommended to Congress as unsuitable, be released for multiple purpose use; and other similar approaches.
- o Clarify for exemptions for small temporary collection devices and consider permitting land treatment of oil and gas wastes.
- o Nuclear licensing reform, reauthorization of the Price-Anderson Act, and progress in development of a nuclear waste repository.
- o Take a hard look at introducing more competition into electric power markets.
- o Aggressively push for higher levels of strategic oil stocks in all countries at the ministerial meeting of the International Energy Agency in May, followed by the President addressing the matter at the Venice summit.
- o Evaluate regulatory changes to facilitate the use of alternative fuels (alcohol and compressed natural gas) for the transportation sector.

### DISCUSSION

Administration policies implemented to date and previously approved proposals will contribute to a more secure energy future in the long term. If all policies are implemented (particularly comprehensive natural gas deregulation), these policies can yield additional production of 375,000 barrels per day of oil equivalent within a 3 to 5 year period.

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Against this backdrop, the EPC/DPC should focus on: 1) To what degree is there a national security threat? 2) Are present policies adequate? 3) Should the Administration adopt DOE's three-pronged approach for enhancing energy security? 4) How should new initiatives be funded?

## Is There a National Security Threat?

The national security implications of projected levels of dependence on insecure sources of oil are significant. The following discussion has been prepared by the State Department, the Department of Defense, the Central Intelligence Agency and the National Security Council.

### Growing Reliance on Insecure Oil Affects National Security Interests

Over the next decade, the West, including the United States, will become more dependent on insecure oil supplies, particularly from the Persian Gulf. This poses a threat to US national security interests. The decline in surplus production capacity will leave the West more vulnerable to supply disruptions, price manipulation, and attempts to use oil as a political weapon.  
(C/NF)

### Political Instability in the Persian Gulf

Increased dependence on the Persian Gulf for oil supplies is a concern because of the continuing volatility in the region and the threat of a supply cutoff or a major supply disruption. The course of the Iran-Iraq war, an almost certain power struggle in post-Khomeini Iran, and Soviet competition for influence in the region all influence Western access to Persian Gulf oil. Furthermore, developments in the Arab-Israeli arena could again bring Middle East politics to the forefront of oil policy decisions as they did in 1973. (C/NF)

The countries in the Arabian Peninsula will face continuing and perhaps increased political, economic, and social pressures over the next decade. The political stability of these states over the past 30 years has been particularly remarkable in light of their rapid economic and social development. Changing political, economic, and social environments, however, are likely to stimulate increased political activism that could lead to periods of instability in some of these states before the end of the century. Ruling families will face more complex challenges as they try to meet the rising expectations of increasingly educated

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and rapidly growing populations. Thus when combined with the hostility between Iran and Iraq the risk of political instability in the Persian Gulf area will remain high. (S/NF)

Although political change on the Arabian Peninsula would not necessarily be inimical to US interests, instability could be exploited by external elements hostile to the United States. Radical domestic groups probably would receive external support, and their antiregime activities may well include an anti-US focus. (S NF)

## U.S. Interests

Energy security policy must deal with two environments -- reducing our vulnerability to supply disruptions prior to their occurrence and preparing us to cope with supply interruptions.

National security is affected by our energy situation in several ways:

- o Economic Impacts. Strong economies are essential to Western security. Thus, national security is enhanced by the contribution lower oil prices and a market-based energy system make to economic growth and efficiency. Strategic stocks give oil-importing nations the capability to mitigate most of the economic impact of historic-sized disruptions. However, as the cushion of surplus production capacity diminishes, our ability to cope will be reduced. Under these conditions, supply disruptions or price manipulation could seriously damage the world economy and undermine our ability to pursue our security objectives. (C/NF)
- o Defense Requirements. Although defense needs are small relative to overall oil consumption, disruptions can hamper defense readiness and sustainability during periods of international crisis or during times of war. Moreover, defense needs in a major conventional conflict would include industrial mobilization. Ensuring that defense demands are met may mean that discretionary civilian consumption would yield to security requirements in an emergency. (U)
- o Foreign Policy Implications. Increasing dependence on insecure oil can hamper pursuit of U.S. security and foreign policy interests. Heavy and growing reliance on the Persian Gulf region requires that we continue to devote limited defense readiness resources to this area, stretching our global defense capabilities. Our own political willingness to pursue fundamental long-term interests could be reduced if special priority must be accorded to ensuring oil supply. Support from Allies could also be reduced if they respond to perceived vulnerabilities and rivalries for oil supplies, thus undermining Allied solidarity and complicating the

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management of a major crisis. Heavy reliance on the Persian Gulf may also reduce Allied willingness to provide access to military facilities essential for U.S. capabilities to respond to crises in the Middle East/Southwest Asia region. Following the U.S. bombing of Libya, for example, Tripoli pressed hard for an Arab oil embargo against the United States and Allies who supported the effort. The Arab world -- including Egypt -- strongly condemned the U.S. action, but did not pursue an embargo in part because of the abundance of alternative supplies. In a tight oil market, fear of unified Arab retaliation might have stiffened Allied resistance to the bombing. (S/NF)

Energy security can be achieved only on a collective basis. Measures aimed at ensuring our access to oil supplies at the expense of our Allies not only will fail, but also will encourage them to pursue go-it-alone strategies that are likely to be harmful to our interests. ~~In contrast~~, cooperative efforts to reduce collective vulnerability give the United States greater flexibility in foreign policy and add to our national security. National security is enhanced when the U.S. and its Allies minimize, in a cost effective way, the risks of a supply disruption (and maintain the capability to mitigate its impacts should one occur). (U)

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**Should the Administration Adopt DOE's  
Three-Pronged Approach?**

If council members conclude that projected falling U.S. production, growing OPEC market share, and increasing dependence on Persian Gulf oil jointly pose and increase a national security threat, they should assess the adequacy of present policies and consider any new policy initiatives that may be needed.

DOE and others believe that present policies are not adequate. Growing dependence on insecure sources of oil exposes the Nation to the threat of supply disruptions, places economic power in the hands of foreign cartel members, exposes our economy and industry to oil market manipulation, constrains the conduct of foreign policy and limits our freedom of action in strategic areas of the world. This represents a serious national security threat that requires strong action by the Administration. The President has stated that the United States must not become hostage again to a foreign oil cartel and that the Nation must maintain a viable and competitive domestic oil and gas industry. In recognition of the President's goals, DOE has proposed a goal of increasing oil and gas production by up to 1 million barrels per day in the early 1990's which includes the amount of lost production in 1986 and to thereby reduce increasing dependence on imported oil. DOE proposals are targeted to increasing domestic production and finding new U.S. reserves and are designed to stimulate drilling in the U.S. to help sustain the oil service industry and independent oil and gas infrastructure which drills 85% of new wells in the U.S.

Some hold the view that present policies are adequate and that it would be consistent with Administration policy to let markets, rather than government, allocate resources. It is pointed out that the proposed new tax and spending initiatives could add as much as \$8 billion over five years to the cumulative budget deficit. Supporting tax incentives for the oil industry would make it difficult to fend off demands for special tax treatment for other energy sources and other industries with national security claims such as steel, semi-conductors and airframes. In addition, offering tax incentives for the oil industry dissipates administration political capital and diverts time and attention from proposals, such as natural gas decontrol, which are consistent with market economics and deserve Administration support. Additional initiatives could launch a government directed oil import reduction campaign and undercut national security by weakening the economy and reducing resources in the federal budget available for defense and other national security purposes.

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The Department's proposal to increase U.S. oil and gas production by one million barrels per day partially consists of previously-approved but not yet implemented market-based incentives (mainly natural gas deregulation). These market-based initiatives will result in increased U.S. production of oil and gas of 375,000 barrels a day, or 40 percent of DOE's target. The remainder would result from a series of proposed new tax incentives. This total increase in U.S. energy production, equivalent to 1 million barrels per day of oil, would raise domestic oil and gas production by about 6 percent above what it would otherwise be. This gain would reduce projected net U.S. oil imports by 8 to 11 percent. If achieved by 1992, the gain in U.S. production would reduce world dependence on Persian Gulf production by 0 to 5 percent, depending upon OPEC response. It should be noted that roughly 30% of these effects result from natural gas deregulation.

To provide enhanced energy security and reduce dependence on insecure foreign sources of oil, DOE has recommended a three-pronged strategy. First, temporary tax incentives to stimulate oil exploration and development. Second, exploration of the Arctic National Wildlife Refuge, which could have oil reserves comparable to Prudhoe Bay. And third, a faster build of emergency stocks. These and other options developed by the Working Group are described below.

## **1. TAX INCENTIVES**

DOE recommends the following items as a four-part energy security tax package designed to encourage exploration and development drilling and to preserve stripper and other marginal wells. The first two items were previously approved by the EPC with a sunset provision at \$20.

**ITEM 1:** Repeal the transfer rule, to permit use of percentage depletion for proven properties which have changed ownership.

The estimated cost of repealing the transfer rule averages \$17 million per year, or \$85 million for the five year period in lost tax revenues from 1988-1992. Oil and gas production would increase by 55,000 barrels per day by 1990, largely from maintaining low-production wells that otherwise would be abandoned.

**ITEM 2:** Increase the net income limitation on the percentage depletion allowance from 50% to 100% per property.

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The cost of increasing the net income limitation is \$31 million per year, or \$155 million for the five-year period in lost tax revenues from 1988-1992. This option would maintain oil and gas production of 58,000 barrels per day from marginal properties that would otherwise be shut-in by 1990.

**ITEM 3:** Provide for faster recovery of Geological and Geophysical (G&G) expenses, with a phase-out of the option as oil prices rise from \$21 to \$25 per barrel.

G&G costs include work that precedes exploratory drilling. Currently, these costs (which account for about 12% of exploratory costs) must be capitalized and recovered over the producing life of the asset. Permitting the recovery of G&G costs, as is now allowed for intangible drilling costs (IDCs), would simplify oil company recordkeeping and speed up the recovery of these costs.

The average annual cost of this provision in lost tax revenues would be \$306 million per year from 1988-1992 (resulting in increases in tax collections by 1994). The five year revenue loss is \$1.53 billion. The provision would increase oil and gas production by 200,000 barrels per day by 1992.

- PROS:**
- o The incentive is among the most efficient of those considered.
  - o G&G costs can be viewed by some as similar to research and development costs and should be accorded a faster writeoff period as are R&D costs in other industries.
  - o By targeting G&G expenditures, this option directly promotes an increase in the search for oil and gas reserves, increasing future domestic production capacity.
  - o By shifting the time profile of production of oil and gas toward the present, energy security will be increased during the 1990's, a time when the world will be most dependent on oil. Cash flow from new production can be plowed back into further exploration.

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- o DOE estimates that shifting the time profile of production to the near term would only marginally reduce the availability of reserves in future years.
- o Phasing out this incentive as oil prices rise curtails cost as price incentives become adequate.
- o Both independent oil producers and the oil service sector reported financial losses for 1986, and the incomes for major producers for domestic operations declined by 65 percent.

**CONS:**

- o The subsidy amounts to a significant amount per barrel for each additional barrel of increased production and will be viewed as fundamentally inconsistent with the Administration's market reliance energy policy.
- o Major oil companies will be reporting in excess of \$12 billion in net income in 1986. Providing a subsidy to them will be viewed by some as a bailout to a profitable sector.
- o Providing a temporary subsidy increases U.S. production in the early 1990's but results in lower U.S. production in the longer term and increased import reliance and reduced security.
- o Without legitimate budget offsets, would substantially increase the deficit at a time when deficit reduction is a high priority.
- o Would be a major compromise to the recently enacted tax reform that eliminated from the tax code most special interest subsidies.

**ITEM 4:** Provide a tax credit for oil exploration and development on new properties.

Allow an exploration and development drilling credit equal to 10% on the first \$10 million of annual drilling expenditures and 5% on expenditures in excess of \$10 million.

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Expenditures eligible for the credit include E&D drilling and equipping costs on unproven properties, and expenditures to maintain stripper well output, such as maintenance, workover and secondary recovery costs. This credit could be used in full for either regular tax or minimum tax payments, and it would be refundable. The credit would terminate when prices reach \$25 per barrel.

The cost of this option is \$2.8 billion over five years, of which drilling credits represent \$525 million per year from 1988-1992. By making the credit non-refundable, the cost would be reduced by \$425 million over five years, or \$85 million per year, and the production response would also be reduced.

- PROS:
- o Directly targets new exploration, drilling, and production by reducing the cost of finding and developing new oil reserves in the U.S. while prices remain low. Production of oil and gas is estimated to increase by 330,000 barrels per day from the refundable drilling credit alone.
  - o Would slow the abandonment and plugging of stripper wells and encourage workovers and drilling and other producing zones resulting in increased production estimated at 30,000 barrels per day (not already brought on by Items 1 and 2).
  - o Provides cash flow to many domestic oil drillers, helping to offset damage to the domestic industry caused by the collapse in prices and the decline in investment.
  - o By shifting the time profile of production of oil and gas toward the present, energy security is increased during the 1990's, a time when the world will be most dependent on oil. Cash flow from new production can be plowed back into continuous exploration.
  - o DOE estimates that shifting the time profile of production to the near term would only marginally reduce the availability of reserves in future years.
  - o Since the credit is not restricted to any particular geographic region, the credit would not alter market incentives to explore and develop the most promising areas.

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- o Both independent oil producers and the oil source sector reported financial losses for 1986, and the incomes for major producers for domestic operations declined by 65 percent.
- CONS:
- o The stripper provisions would provide incentives for some producers to reduce their production levels simply to qualify for the credit.
  - o The subsidy amounts to a significant amount per barrel for each additional barrel of increased production and will be viewed as fundamentally inconsistent with the Administration's market reliance energy policy.
  - o Major oil companies will be reporting in excess of \$12 billion in net income in 1986. Providing a subsidy to them will be viewed by some as a bailout to a profitable sector.
  - o Providing a temporary subsidy increases U.S. production in the early 1990's but resulting in lower U.S. production in the longer term and increased import reliance and reduced security.
  - o Without budget offsets, would substantially increase the deficit at a time when deficit reduction is a high priority.
  - o Would be a major compromise to the recently enacted tax reform that eliminated most special interest subsidies from the tax code.

#### Summary of Tax Incentives

The four tax items will yield 683,000 barrels per day of additional production and, when combined with natural gas decontrol and California offshore leasing, will contribute over one million barrels per day of oil and gas.

The cost of the tax incentives is \$938 million per year or \$4.69 billion for the 5 year period.

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**2. LEASING AND ACCESS TO FEDERAL LANDS**

Federal lands have tremendous potential for new significant oil and gas discoveries. Offshore has a potential of more than 11 billion barrels of recoverable oil. Onshore, the Arctic National Wildlife Refuge alone has a potential of up to 30 billion barrels of oil in place with a recoverable reserves potential of up to 9.2 billion barrels.

**ITEM 1:** Open the Arctic National Wildlife Refuge for Oil and Gas Exploration. "Leasing through an orderly public process in a manner fully respective of the environment".

**PROS:**

- o The coastal plain of the Arctic National Wildlife Refuge (ANWR) is the nation's best single prospect for major new reserves (up to 9.2 billion barrels of recoverable oil).
- o Production potential could be up to 1.5 MMBD coming on stream beyond 1995 as a long-term replacement for Prudhoe Bay production.
- o ANWR production could use available pipeline capacity as Prudhoe production declines.
- o New ANWR production would replace an equal volume of import demand.

**CONS:**

- o Oil exploration activities could impinge on this environmentally fragile region.
- o This region is habitat to wildlife and has historically served as a source of subsistence for some native populations.

**ITEM 2:** Reduce the minimum bid requirement for Federal leases from \$150 per acre to \$25 per acre.

**PROS:**

- o At the present minimum, a bidder must offer at least \$864,000 for the typical 5,760-acre tract. At \$25 per acre, the minimum bid for a standard tract would only be \$144,000.
- o This option could increase the number of leases bid on and awarded by as much as 40 percent of lease sales in the Gulf of Mexico.

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- o Increased leasing would likely increase production, depending on future oil prices (no estimate of production response is available). Increased royalties from increased production would offset some of the lost bonuses from reducing the minimum bid.
- CONS:
  - o Bonus receipts could drop about \$100 million for the FY 1988 to FY 1992 period. Applying a \$75 per acre minimum bid to deep water tracts only would reduce receipts in the FY 1988 to FY 1992 period by about \$20 million.
  - o Opponents may wrongly claim that the government was selling the Nation's natural resources (which belong to everyone) at too low a price.
- ITEM 3: New competitive lease sales would be offered with no royalty requirement.
- PROS:
  - o Bidding on new leases would reflect the expected present value of future earnings on the leases free of royalties. This means the government, including state governments, would receive their payment up front. This is equivalent to additional revenue of \$2 to \$3 per barrel to lease operators.
  - o Some tracts that would not have been bid on because of the obligation of paying royalty would now receive bids, increasing the amount of oil produced. Producers will maintain production longer, without the need to go through an administrative royalty reduction procedure.
  - o Total oil production and near-term receipts by the government should go up. Federal bonus revenues on offshore oil should rise about \$220 million in FY 88 and about \$1.5 billion in total from FY 88 through FY 92.
  - o The production gain begins 5 or more years after leases are issued. Additional production would be about 20,000 b/d in 1995 and 60,000 in 2000.

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- CONS:**
- o Drilling activity on Federal lands could be reduced if lessees cannot fund the up-front cost of lease bonuses compared to deferred royalties lessees.
  - o Federal revenues would be reduced (long-term present value) if lessees have cash constraints, or are more sensitive to risk on a limited portfolio of leases than the government is on its large portfolio of all leases.
  - o To the extent lease bids rise to match royalty reductions, some of the increased lease value will be eroded.
  - o Risk that no oil will be recovered is shifted to the lease operators from the government as landowner.
  - o States may demand their normal share of Federal royalties, which would increase Federal outlays by as much as \$20 million per year.

### 3. Exports of Californian Crude Oil

- Item 1:** Remove the restrictions which now exist on exporting crude oil from California.
- Commerce estimates that, if these restrictions were eliminated, exports would increase about 50,000 to 100,000 barrels per day.
- PROS:**
- o Can be done administratively, by a finding (such as the Commerce Secretary made in 1985 authorizing oil exports to Canada) that exports are in the national interest.
  - o Consistent with sound economics; promotes efficiency and higher incomes; contributes to a more competitive economy and helps the balance of payments; helps oil producers in California and relations with Japan and other Pacific rim countries.
  - o Increases the sale price of the Elk Hills Naval Petroleum Reserve by about \$100 million since higher oil prices (of up to \$1 barrel) make the oil field more valuable.

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- CONS:**
- o Political resistance to the proposal in Congress is likely to be very strong.**
  - o Could undercut the proposal to open-up ANWR, since opening up ANWR will be portrayed as putting the U.S. environment at risk to fuel the Japanese economy.**
  - o Could lead to a total ban on the limited oil exports which are now allowed (primarily from Alaska's Cook Inlet and to Canada).**

#### **4. EMERGENCY PREPAREDNESS OPTIONS**

The Administration's commitment remains firm to fill the Strategic Petroleum Reserve to 750 million barrels. The SPR presently contains 516 million barrels of crude oil acquired since 1977. The 1987 fill rate is 75,000 barrels per day and the President's budget calls for a 35,000 barrels per day fill rate in 1988. Under current projections, imports may rise to 6 to 8 MMBD in 1990 and 8 to 10 MMBD in 1995, and therefore an accelerated fill rate should be considered.

**ITEM 1: Fill the SPR at 35,000 barrels per day.**

- o Achieves 750 million barrels in 2004.**
- o Provides 62 to 85 days of import protection in 1995.**
- o This fill rate is proposed in the current budget.**

**ITEM 2: Fill the SPR at 75,000 barrels per day.**

- o Achieves 750 million barrels by 1995.**
- o Provides 18% or 11-15 more days of import protection by 1995 than does the 35,000 fill rate.**
- o Increases outlays for SPR oil purchases by \$307 million in 1988 and by \$2.1 billion from 1988-1995 compared to 35,000 b/d.**

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**ITEM 3: Increase the SPR fill rate to 100,000 barrels per day until reaching 750 million barrels.**

- o Achieves 750 million barrels by 1993.
- o Achieves import protection of 83-110 days in 1993 and 74 to 99 days of imports in 1995.
- o Increases outlays for SPR oil purchases by \$482 million in 1988 and by \$3.3 billion during 1988-1993.

**ITEM 4: Increase SPR fill rate through tax incentives.**

Seek to increase the SPR fill rate through tax incentives designed to encourage the private sector to place domestic oil in the SPR. The private sector will retain title to the domestic oil, with the Federal Government having control of the types and quality of domestic oil to be stored and the conditions for its release.

Specifically, the private sector would contribute up to 75,000 b/d to SPR. The private sector would pay all transportation costs to and from all SPR terminals. The government would provide for the storage, maintenance and operation of the SPR and eligibility for two tax incentives.

In the event that the private sector does not fully respond to the stock building incentive, the Secretary of Energy would resume publicly financed purchases to assure a minimum total fill rate of 35,000 barrels per day. .

- PROS:**
- o Provides opportunities for private petroleum users to participate in a supply insurance program.
  - o Increases SPR inventory while reducing near term budget deficit impact.
  - o Would increase market efficiency by involving many parties in decisions regarding the risk of future disruption.
  - o Creates a new constituency to support free market policies.

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- CONS:**
- o Significant number of administrative burdens including verification of oil quantity and specifications, accounting of each participant's inventory, scheduling of deliveries consistent with leaching programs, and drawdown/distribution procedures.
  - o Complex logistics of providing domestic oil to existing SPR terminals, involving a potentially large number of private sector participants. The SPR was designed to be a bulk wholesaler to a continuous retailer.
  - o Would require major statutory changes, including minimum fill rate requirements.
  - o Would be viewed by some as private profiteering in the event of a severe oil supply disruption.

The effectiveness of emergency preparedness is greatly strengthened when all countries maintain adequate emergency stocks and coordinate their use. Our allies and trading partners currently hold about 350 million barrels of emergency reserves. Japan for example has committed to SPR of only 189 million barrels even though they are 100% dependent on imported oil and import over 4 MMBD. The U.S. has a SPR substantially larger than other importing countries and has had some recent modest success in getting others to increase stocks. All agencies believe the U.S. should strongly urge other countries to increase their strategic stocks, otherwise unilateral U.S. action serves as a subsidy to protect all oil consuming nations without a fair sharing of the costs.

#### Contribution From Other Energy Sources

The full spectrum of action needed to meet the national security concerns must, in addition to the foregoing supply and emergency preparedness options, address activities to decrease consumption of oil and gas and to recognize the displacement of oil and gas by other energy sources.

The Energy Security Study examined in detail the potential contribution from a wide variety of energy sources, including coal, nuclear, renewables and conservation. The Study shows that these sources will play a significant role in furthering U.S. energy security under present policies, and thus no additional actions appear warranted at this time.

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**How should new initiatives be funded?**

Attached is a chart which summarizes the budget impacts of the various options. Some of the options result in increased costs relative to the President's budget. Others generate increased revenues. The total net effect depends on the particular combination of options selected.

**CONGRESSIONAL OUTLOOK**

Moving legislation on the Hill would be affected by a number of factors. If an adequate demonstration is made that a long term energy security problem exists, there are significant elements on the Hill that would actively pursue legislation to address this problem which could lead to some form of legislation this year. The scope of such legislation is difficult to predict at this time and would depend to a significant extent on the ability of industry groups and other constituencies to make their input and views known to the Congress.

**SPR/NPR Linkage**

Congress consistently has required that the SPR be filled at rates greater than those proposed by the Administration. There are indications that Congress will legislate substantially higher rates in FY 1988. Similarly, there has been opposition to Administration proposals for the sale of the Naval Petroleum Reserve. We may be able to achieve our objective of selling the NPR by linking it to an expanded SPR fill rate. The estimated sale price of the NPR is \$3.3 billion which would almost totally offset the highest fill rate. However, it must be noted that the sale of the NPR is already included in the FY 1988 budget.

**Legislation**

Twenty-eight bills have been introduced in the 100th Congress related to oil and gas issues. These range from repeal of the Fuel Use Act (FUA), to imposition of import fees on imported oil, to establishment of ceilings on crude oil and product imports.

Legislation receiving most active consideration thus far is a house bill to repeal FUA (HR 309 and companion HR 1796). Other major legislation includes:

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- o Energy Security Act of 1987 (S.694) introduced by Senator Bentsen (D-TX) would require the President to establish a national oil import ceiling not to exceed 50% of U.S. crude and products consumption for any given year. To prevent the ceiling from being exceeded, the President, with Congressional approval, would have authority to impose import fees, expand the SPR, and provide incentives for domestic production. The bill has bi-partisan co-sponsorship of twenty-two senators.
- o The Energy Security Tax Act of 1987 (S.846), introduced by Senator Nickles (R-OK) would repeal the windfall profit tax; provide a 27.5% depletion allowance for stripper production; and eliminate the alternative minimum tax for intangible drilling costs.
- o Senator Gramm is expected to re-introduce the Oil and Gas Revitalization Act of 1986, with some additional measures such as depletion allowance and tax credits.
- o Representative Edwards (R-OK) has introduced legislation to increase the oil depletion allowance from the current 15% to 27.5%.

#### Sense of Congress Resolutions

- o House resolution 16 was introduced in January by Congressman Conte (R-MA) and co-sponsored by 39 Republican and Democratic lawmakers, expressing opposition to imposition of import fees on oil and refined products.
- o Senate resolution 97, introduced by Senator Pell (R-RI), opposes action by either Congress or the President to impose fees on imported crude oil or products.

#### Omnibus Budget Reconciliation Act of 1986

The Omnibus Budget Reconciliation Act of 1986 required the Secretary of Energy to "conduct a study of domestic crude oil production...and the effects of imports...in determining ...whether such production...is adequate to protect national security". The Energy Security report fulfilled this part of the requirement.

The Act attempts to require the President within 45 days after the report is transmitted to Congress to report his "views concerning the levels at which (oil) imports become a threat to national security and advise the Congress concerning his views of the legislative or administrative action, or both, that will be required to prevent imports...from exceeding those levels...."

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**Although there is some question on the constitutional validity of this requirement, the Congress is expecting the President to report his views on energy security by May 1, 1987.**

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Talking Points for the ADCI  
Instability and Oil Security in the Persian Gulf  
9 April 1987

Continued political volatility in the Persian Gulf region will generate risks to the flow of oil well into the 1990s.

Although the countries on the Arabian Peninsula have remained intact and pursued consistently moderate policies over the past several decades, they will face continuing, and perhaps increased, political, economic, and social stress in the years ahead.

- A prolongation of the depressed economic conditions in the Gulf monarchies is likely to stimulate increased political activism that could lead to periods of protracted instability in some states.
- The rising expectations of increasingly educated and rapidly growing populations will pose complex challenges to these states.
- Ethnic and religious tensions, particularly in Kuwait, Bahrain, and to a lesser extent Saudi Arabia's Eastern Province, are unlikely to dissipate and may well worsen, fueled by the region-wide fundamentalist trend.
- The security relationship with the United States, while a vital element of the national security policy of each of the Gulf monarchies, will continue to be a lightning rod for political opposition.
- Interstate conflict on the Peninsula will remain an ever-present risk as a result of festering border disputes and historical rivalries.

Post-Khomeini Iran is likely to witness an intense power struggle and possibly protracted instability.

- There is a good chance that more radical clerics will remain powerful. Should they gain a dominant position, Iran would likely pursue a policy of greater isolation, be more confrontational with the West and Tehran's Gulf neighbors, and pursue more radical oil policies.

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The 6-year-old Iran-Iraq War shows no sign of ending and poses the most likely continuing threat to the physical production and movement of oil.

--In 1986 alone the two combatants attacked nearly 100 oil tankers in the Gulf and Iraq repeatedly struck Iran's oil production facilities, although these attacks did not diminish significantly the flow of oil from the Gulf.

--Of the war's potential outcomes, an Iranian victory would be most damaging to Western oil interests. The Shia populations in the Arab Gulf states would become more politicized. Iranian control of Iraqi oil policy and influence over Kuwaiti and Saudi policy would make Tehran a much more formidable power in OPEC.

--The war has spurred a trend to find alternative routes for exporting oil that skirt the Strait of Hormuz chokepoint. This trend may ultimately dilute the threat to oil security if pipelines continue to be built that allow Persian Gulf oil to be exported through the Mediterranean, Red Sea, Gulf of Oman, and Arabian Sea ports.

Dramatic developments in the Arab-Israeli arena could again bring Middle East politics to the forefront of oil policy decisions.

--The Intelligence Community judges that the chances are high for a major conflict between Syria and Israel before the end of this decade.

--Under circumstances of growing Western dependence on Persian Gulf oil, the use of oil as a political weapon would regain credibility.

With roughly 55 percent of the world's proven oil reserves, the Persian Gulf will remain a focus of US-Soviet competition for influence.

--A Soviet military move into Iran, while currently a remote possibility, would have major consequences for Western access to oil.

--The US security presence in the region has declined markedly in the past decade as a result of the overthrow of the Shah, the decline in the US weapons relationship with the Gulf Arabs, and growing Arab military self-reliance.

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9 April 1987

DOE Energy Security StudyBackground--CIA Role

In September 1986, following the sharp fall in world oil prices, the President commissioned the Department of Energy to prepare an interagency study on energy security in response to his concern over declining domestic oil production and rising oil imports. At the request of Deputy Secretary of Energy William Martin [REDACTED] and OGI staff provided most of the world energy outlook section of the study. [REDACTED]

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Summary of Findings

The energy security study found that lower supplies from non-OPEC countries, especially the United States, combined with higher oil consumption will leave the world more dependent on Persian Gulf oil supplies in the 1990s. This outlook and the impact of the price fall on the domestic petroleum industry has potentially serious implications for US national security. [REDACTED]

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Rising Dependence on Imported Oil

The price fall already has led to fundamental shifts in market trends--declining non-OPEC supplies and rising consumption--that will cause the West to become more dependent on OPEC and Persian Gulf oil producers.

/o/ The price slide has affected US oil production because the US is the world's high cost producer. US output declined last year and is expected to fall another 400,000 b/d this year.

/o/ The Free World gets half of its energy from oil and oil meets over 40 percent of US energy consumption. Oil will remain a critical component in the world energy market. [REDACTED]

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To bracket likely Western and US dependence on OPEC and Persian Gulf oil producers by 1995, two oil price paths were examined:

/o/ A higher dependence case with an oil price of \$15 per barrel until 1990 rising to \$23 by 1995.

/o/ A lower dependence case of steady price increases from \$15 per barrel in 1986 to \$28 in 1995.

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/o/ Under these cases, free world dependence on OPEC oil rises from 40 percent now to 45-60 percent by 1995; dependence on Persian Gulf producers increases from 25 percent to 30-45 percent.

--For the US, net oil imports rise from 5.2 million b/d in 1986 (33 percent of consumption) to 8-10 million b/d (50 percent of consumption) by the mid-1990s. [ ]

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Risks of Disruptions--Increasing Producer Leverage

Rising dependence on OPEC and Persian Gulf oil implies a greater vulnerability to oil supply disruptions and greater economic and national security risks for the United States and our Allies. Energy security depends in part on the ability of importing nations to respond. Consuming countries have taken steps to increase strategic oil stocks, but the risk of a large oil supply disruption in the Persian Gulf that damages the economies of the United States and allied nations remains. Interconnected world markets dictate an international approach to increasing energy security. [ ]

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Study Conclusions

Secretary Herrington concludes there is justification for national concern over rising US and Allied dependence on imported oil and on the declining competitiveness of the US petroleum industry. The Energy Security study examines policy options and impacts to deal with the outlook, but makes no explicit recommendations. Implicitly, however, the study concludes that the economic and trade costs of an oil import fee outweigh energy security benefits. [ ]

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10 April 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING

EPC/DPC

DATE

Tuesday, 14 April 1987

TIME

1100

PLACE

Roosevelt Room

CHAired BY

Baker

ATTENDEE(S) (probable)

ADCI

SUBJECT/AGENDA

Energy Security

PAPERS EXPECTED

By Monday, 13 April

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*Mr. J. A. ... 4/10*

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16 March 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

**TYPE OF MEETING**

Economic Policy Council

**DATE**

Wednesday, 18 March 1987

**TIME**

1100

**PLACE**

Roosevelt Room

**CHAIRMAN BY**

Baker

**ATTENDEE(S) (probable)**

NIO/Econ

**SUBJECT/AGENDA**

Farm Credit System

Canada FTA

**PAPERS EXPECTED**

Agenda by COB 17 March

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*Deane Hoffmann  
attended***SECRET**

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Date

3637 (10-81)



THE WHITE HOUSE

WASHINGTON

March 17, 1987

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER

EM

SUBJECT: Agenda and Paper for the March 18 Meeting

The agenda and paper for the March 18 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Roosevelt Room.

The first agenda item will be the Farm Credit System. The Administration is facing growing pressure to take action to strengthen the Farm Credit System. The Working Group on Farm Credit has reviewed the financial condition of the System and prepared several options for the Council's consideration. A paper prepared by the Working Group is attached.

The second agenda item will be a progress report on the free trade agreement negotiations with Canada. The Council will consider this issue in preparation for the President's visit to Canada. There will be no paper for this agenda item.

attachment

**ECONOMIC POLICY COUNCIL**

**March 18, 1987**

**11:00 a.m.**

**Roosevelt Room**

**AGENDA**

- 1. Farm Credit System**
- 2. Canada Free Trade Agreement**

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: The Working Group on Farm Credit

SUBJECT: Options for the Farm Credit System

I. Background

The passage of the Farm Credit Amendments Act of 1985 established the means for the System to utilize its own resources to deal with losses and restructured FCA as a more effective, more independent regulator. Under these amendments in excess of \$4.5 billion of System surplus has been used to absorb actual losses and establish reserves for future losses of over \$3.5 billion. There is over \$1 billion of surplus left in the System, but most of that is at the local Production Credit Associations and is currently blocked by litigation from being shared with those System institutions whose borrower stock is at risk of being impaired. (The timing of resolution of the litigation is uncertain, and even an additional \$1 billion might not be sufficient to enable all Systems institutions to get through 1987 and 1988 without stock impairment.)

Further amendments were passed in 1986 that provided for the use of regulatory accounting (RAP) to amortize "excess" loan loss and debt cost expense over 20 years, so as to gain further time for correction of the System's problems in hopes of earning the amortization back in the future. While RAP did buy some time, most analysts of the System believe that something fundamental will have to be done by mid-1987, and both the House and the Senate are starting to develop legislation.

The agricultural economy on which the System's recovery depends remains in a depressed, shakeout mode; the System has shrunk by over \$20 billion in net loans outstanding since December 31, 1984 without being able to get rid of a substantial amount of non-callable high rate debt; non-performing loans and System operating losses continue at high levels; and dissension in the System between contributing and receiving institutions is very high and likely to continue to produce litigation.

The pressures for action this year are: (i) Congressional interest in "helping farmers"; (ii) impairment of borrower stock in some districts; (iii) lack of collateral for some banks to continue borrowing; and (iv) a risk (much less likely) that market access could be impaired by extended inaction.

- 2 -

The issue of borrower stock is one of the more difficult to deal with. Borrowers have viewed the stock more as a compensating balance (to be paid off at par when their loan is retired) than real capital available to absorb losses, and the Congressional intent in the 1985 amendments appeared to be strongly supportive of protecting its value. Having to buy borrower stock when its value is being questioned affects the ability to get new, good borrowers. It is, however, a cushion we would like to figure out how to invade prior to any cash infusions, against the possibility of a future upturn in agriculture restoring its value. (Converting fully to "real, hard capital", while very desirable, is very unlikely at this time of large and unknown losses and would have to be squared with the cooperative structure of the System in any case.)

## II. Premises and Objectives

1. Any option pursued should provide incentives for improvement of operating practices and structural reforms to provide for longer term profitability of System entities.
2. It is necessary to maintain the System in some form as a viable source of agricultural credit. (Congress and agricultural groups realize that commercial banks and insurance companies will not fill the System's role, particularly in farm mortgages, without government support; and expanding FmHA's role is not acceptable.)
3. Any government assistance/guarantees portion of an option should produce the smallest and latest budget outlays possible.
4. The only funds available to absorb further operating losses and loan deterioration are (a) the small amount of remaining surplus, (b) borrower stock, (c) debtholders, and (d) the taxpayer. (The existing loan loss reserves will at best cover only the ultimately realized losses currently estimated to be in the portfolio.)
5. The extremely high likelihood of some legislative action this year makes it essential for the Administration to have its views formulated clearly in advance so as to avoid bad outcomes and maximize opportunities to develop a coordinated approach with the Farm Credit Administration (FCA), GAO and CBO. (GAO is writing a report on legislative options which is due to be presented in March.)

- 3 -

### III. Basic Options

The Working Group considered and unanimously rejected three possible approaches:

- 1) "Wait and see" (and probably be overtaken by Congressional action.)
- 2) "Activate existing mechanism" (and provide an open-ended draw on the Treasury while failing to achieve any reform of the System.)
- 3) "Have bondholders take the hit" (and cause a System default, jeopardize the value of outstanding securities and ability to finance of other government sponsored enterprises, and create large and probably unacceptable ripple effects through the economy (particularly housing) and the financial structure.)

As a result the Working Group recommends that a package proposal, containing both financial assistance and restructuring pieces, be advanced as early as possible in the Congressional deliberations. Two basic proposals have been advanced in pursuit of this approach:

Option 1: CEA proposal to buy out the existing stockholders and restructure the FCS into a private Loan Company

#### Pros

- o eliminates all further government involvement with FCS
- o eliminates cooperative structure's confusion over rights to profits
- o positive financial management incentives from having hard, at-risk capital in place
- o makes remaining surplus freely available throughout the System

- 4 -

Cons

- o requires at least \$5 billion cash and budgetary outlay, and possibly a guarantee of outstanding FCS debt
- o increases interest rates to farmers due to loss of "agency" borrower status
- o creates political difficulties from attempt to eliminate a cooperative and withdraw government support for the availability of agricultural credit
- o produces windfall gain to stockholders
  - a) who never pay off their loans, and
  - b) if market value should exceed par

Option 2: Majority proposal for a package of least cost guarantee and back-stop provisions coupled with incentives for longer term financial health for FCS

Pros

- o stretches out any outlay effect through structured and targeted assistance
- o allows at least quasi-market forces to influence ultimate structure and long-term financial viability
- o matches fairly well with likely Congressional desires, GAO recommendations, FCA opinions and FCS views
- o makes remaining surplus fully available

Cons

- o does not maximize financial and managerial incentives
- o does not specify mandatory structural changes
- o creates future potential cash claims on the taxpayer

IV. Specifics of Option 2

- A. Elements the Working Group unenthusiastically accepts as necessary pieces for an acceptable package:

- 5 -

1. Guarantee par value of existing borrower stock through a government promise to pay off stock at par, preferably with a time delay after debt repayment, to the extent that there was no borrower stock capital left. (The budget impact of this should be small to zero, and years away.)
2. Remove the requirement for new borrowers to buy stock, with FCA having to adopt capital adequacy guidelines to force accumulation of retained earnings in the future, probably through increased loan origination fees.
3. Establish a new debt reserve fund to assure System financing in the market (to be financed by risk-based premiums and supported by an open, "no year" appropriated line to the Treasury with a \$5 billion limit and a 10 year life) in return for eliminating System entities' joint and several liability for future borrowings (so as to allow elimination of collateral shortage problems).

B. Elements that we strongly support:

4. Ensure that existing surplus in the System would be fully and freely transferrable through the Capital Corporation, which would come under FCA control, as a result of the borrower stock protection.
5. Facilitate System restructuring by (i) removing all legal bars to merger or devolution without regard to entity type or district boundaries, (ii) allowing intra-System competition across current exclusive territory lines, (iii) requiring outside directors for all System entities, (iv) providing the ability to sell real, at-risk stock, (v) allowing entities to exit the System and re-charter as conventional financial institutions (as long as they leave their surplus behind and remain liable for their own portion of System debt), (vi) making explicit FCA's ability to close terminally insolvent institutions, and (vii) creating clear Congressional intent that operating costs should be reduced.

C. An element which is in dispute:

- 6 -

6. Creating the ability for FCS to buy or guarantee and re-sell long-term land loans originated by others, (i) without requiring a stock investment, (ii) with provision for non-FCS originators' participation in establishing policies and procedures, and (iii) with the requirement that the non-FCS originators retain a 10% or greater at-risk interest in loans sold.

Pros

- o may be a political necessity to get any package moved
- o avoids likelihood that a new, separate government sponsored enterprise will be established to perform this function
- o protects FCS's earnings capacity and lending volume

Cons

- o may widen government role in agricultural credit and its financial exposure to further deterioration in the sector
- o runs counter to desires to privatize GSEs and enhance market-driven credit allocation
- o may increase FCS borrowing costs because of added risk

V. Items to Resist

1. Mandatory bargain purchases of Farmers Home assets by the System.
2. Forbearance and borrowers' rights packages.
3. Full guarantees of System debt.
4. Warehousing of bad loans or foreclosed property.
5. Interest rate buy-down provisions.
6. Cash infusions now. (This may become very difficult to resist as help the farmer rhetoric heats up. Were it to become inevitable, the "least unattractive" approach would be to target any cash to defeasance of the high cost, non-callable debt.)

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The Director of Central Intelligence  
Washington, D.C. 20505

National Intelligence Council

NIC 01184-87  
17 March 1987

MEMORANDUM FOR THE RECORD

SUBJECT: Economic Policy Council Meeting 16 March on Trade Legislation

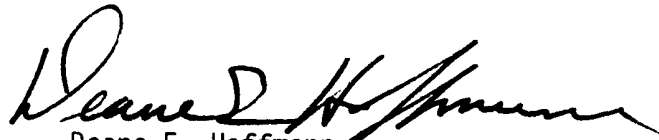
1. The EPC discussed the status of Subcommittee work on HR-3, "Comprehensive Trade Policy Reform Legislation." The object of the meeting was to identify items in the bill sufficiently troublesome to warrant a Presidential veto.

- State Department objected strongly to a proposal to move Presidential discretionary power on trade to the USTR.
- All members objected even to the watered-down version of the Gephardt amendment on retaliation against countries with excessive trade surpluses.


2. OMB reminded agencies that they had only two days to convey their concerns to Chairman Rostenkowski, and that OMB was preparing a letter to send to the Committee.

3. I called [ ] Office of Congressional Affairs, to tell her of the deadline for the OMB letter.

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Deane E. Hoffmann  
National Intelligence Officer for Economics

cc: ~~D/Exec Staff~~   
[ ] OCA (Room 7B14)  
D/OGI

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13 March 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING	Economic Policy Council
DATE	Monday, 16 March 1987
TIME	1100
PLACE	Roosevelt Room
CHAired BY	Baker
ATTENDEE(S) (probable)	NIO/Econ
SUBJECT/AGENDA	Trade Legislation
PAPERS EXPECTED	Agenda by COB today
INFO RECEIVED	Per Cabinet Affairs, 1015

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*Deanne Hoffmann  
to attend*

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Executive Secretary

16 Mar '87

Date

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WASHINGTON**

Attachment

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**CABINET AFFAIRS STAFFING MEMORANDUM**

**Date:** 3/13/87 **Number:** 317,287 **Due By:** -----

**Subject:** Economic Policy Council Meeting - March 16, 1987

11:00 A.M. Roosevelt Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Justice	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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HHS	<input type="checkbox"/>	<input type="checkbox"/>	<del>Svahn</del> Bauer	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HUD	<input type="checkbox"/>	<input type="checkbox"/>	Chew (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
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Education	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Chief of Staff	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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<u>CIA</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Executive Secretary for:	<input type="checkbox"/>	<input checked="" type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>	DPC	<input checked="" type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	EPC	<input type="checkbox"/>	<input type="checkbox"/>
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VA	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

**REMARKS:**

The Economic Policy Council will meet on Monday, March 16, 1987 at 11:00 A.M. in the Roosevelt Room.

The agenda and a background paper are attached for your review.

**RETURN TO:**

☒ ~~Alfred H. Kingen~~ Nancy Risque  
Cabinet Secretary  
456-2823  
(Ground Floor, West Wing)

☐ Don Clarey  
☐ Rick Davis  
☐ Ed Stucky

Associate Director  
Office of Cabinet Affairs  
456-2800 (Room 235, OE08)

Executive Registry

87-1056x

THE WHITE HOUSE

WASHINGTON

March 13, 1987

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER *EM*

SUBJECT: Agenda and Paper for the March 16 Meeting

The agenda and paper for the March 16 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Roosevelt Room.

The single agenda item will be a discussion of trade legislation. A paper prepared by USTR outlining recent changes to the House trade bill is attached.

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**ECONOMIC POLICY COUNCIL**

**March 16, 1987**

**11:00 a.m.**

**Roosevelt Room**

**AGENDA**

- 1. Trade Legislation**

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## THE CO-CHAIRMEN'S PROPOSAL

As of 3/13/87, after Subcommittee Markup:  
Analysis and Comparison with H.R. 3

### SUMMARY

On March 9, Chairman Rostenkowski of Ways and Means and Chairman Gibbons of the Ways and Means Trade Subcommittee issued a new Co-Chairmen's Proposal on Comprehensive Trade Policy Reform Legislation. This Proposal is a substitute for parts of H.R. 3 (which reprinted H.R. 4800, the House Omnibus Trade Bill of last year).

The Trade Subcommittee made a few marginal changes to the Proposal in its markup on March 11 and 12. The Proposal now goes to the full Committee, where markup will begin on March 17. As was the case last year, a comprehensive bill will be assembled (with the Ways and Means bill as the centerpiece), with floor action expected in the last week of April.

While the Chairmen have made a serious effort to accommodate Administration concerns, significant problems remain. We can see already the outlines of the position Ways and Means will stake out for the conference. And on a number of issues important to us, this position is one that could be helpful to us in eventual bargaining with the Senate.

- Although we have not achieved all of our objectives, the trade negotiating authority provided in the Proposal is free from unacceptable conditions, with automatic access to fast track implementation and tariff proclamation authority with no product exclusions. This is essentially the authority that our bill asks for.
- The Proposal also eliminates some of the GATT problems in H.R. 3. Proposals on perishables relief and provisional relief in section 201 have been changed to make them GATT-consistent; deadlines for dispute settlement in 301 cases have been made livable; steel provisions that would have violated our bilateral agreements have been changed.
- There has also been movement on Administration policy concerns. The Proposal eliminates tripartite industry-government-labor policy planning groups from its section 201 proposals. It eliminates mandatory self-initiation of 301 cases, retains broad exceptions to mandatory retaliation in 301 cases, and eliminates the worst of the problems with export targeting. The Proposal also incorporates many of the Administration's legislative proposals.

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Problem provisions remain, however. The most notable include:

- Congressional interference with the organization of trade policymaking, through unwarranted transfers of authority. The Proposal transfers to the USTR Presidential authority under sections 201, 301, 337, 406, and for GSP.
- Intrusion into international monetary policy, by setting statutory targets for exchange rates, and by requiring the USTR to renegotiate some exchange rates.
- The "Gephardt Amendment" proposal on retaliation against "excessive surplus" countries, although it has been improved by removing the mandatory 10% reduction in certain bilateral trade deficits each year.
- A "worker rights" cause of action that makes lack of a minimum wage, or denial of the right to unionize, grounds for trade retaliation.
- Antidumping/CVD proposals such as private right of action for dumping, diversionary dumping, and natural resources subsidies.
- A sectoral reciprocity scheme in telecommunications.

#### SECTION-BY-SECTION ANALYSIS

##### Negotiating Authority/Congressional and Private Sector Consultation

This is the area of the Proposal where the greatest care has been taken to respond to Administration concerns. The Proposal incorporates many of the general and specific negotiating objectives in our bill, and incorporates our bill's provisions on consultation with Congress and the private sector. Most important, it provides negotiating authority that is close to what we have asked for.

It provides non-tariff authority with automatic access to fast track implementation until Jan. 3, 1991. Only the optional 2-year extension is subject to 60-day Committee veto. Even with the Committee veto, this is a far better approach than that in S. 490.

Proclamation authority for tariffs is provided until Jan. 3, 1993. H.R. 3 provided such authority only until 1991, with a possible 2-year extension. A textile amendment excluded import-sensitive products from proclamation authority (which would force a record vote on tariff cuts). The Proposal deals with the import-sensitivity problem by putting a ceiling of 60 percent for cuts on such products, and making such tariff cuts subject to a 10-year phase-in requirement. These conditions are far preferable

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to the product exclusions in H.R. 3, as the products excluded account for a major part of U.S. tariff protection.

### Findings and Actions on Trade Deficit Reduction

This new subtitle includes findings and a statement of policy on reduction of trade and current account deficits and exchange stabilization. It requires yearly reports by the President on his progress in reducing the trade deficit.

### Section 301

The "Gephardt amendment" to H.R. 3 has been significantly cut back, but is still unacceptable. As revised, the ITC would annually identify "excessive trade surplus" countries according to specified criteria (which would initially hit Japan, Korea, Taiwan, Brazil, and West Germany). The USTR would then determine which of these countries maintain a pattern or practice of unfair trade policies or practices.

USTR would then negotiate for 6 months (with a possible 2-month extension) to achieve a more balanced and reciprocal bilateral trading relationship through a bilateral agreement that reduces unfair policies or reduces their effects on U.S. commerce. If negotiations do not succeed, USTR must take action (tariffs, import restrictions or other actions authorized by existing law) against all unfair practices, equal to the burden or restriction. USTR could waive retaliatory action against "unjustifiable" practices if retaliation would cause substantial harm to the national economic interest; for other practices, he could waive retaliatory action if the economic harm caused by retaliation exceeded the harm caused by the unfair practice. Waivers would be subject to Congressional override.

This modification is an improvement over the original Gephardt amendment, which required surplus reduction targets of 10 percent per year, and would have pushed us into import quotas in every case. However, the Proposal has added an unnecessary and unwise requirement that USTR determine whether any "excessive surplus country" maintains its currency at an artificially low level, and negotiate with these countries to seek currency realignment. The provision authorizes trade retaliation if negotiations fail (including an exchange rate equalization tariff, which would tend to push the dollar up). The most fundamental problem with the revised Gephardt amendment is that it contemplates bilateral trade balancing through trade policy rather than macroeconomic policies.

The Proposal still provides for mandatory retaliation in Section 301 cases involving trade agreement violations or other "unjustifiable" practices. However, it keeps H.R. 3's exceptions to mandatory retaliation -- if the GATT council or a panel finds

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there is no violation of U.S. rights; or if the President finds that (a) the foreign country is taking satisfactory measures to grant U.S. trade agreement rights or (b) there is a satisfactory resolution by agreement, or (c) phaseout of the practice is impossible but the country agrees to compensate us, or (d) retaliation is not in the U.S. national economic interest. These exceptions leave the President almost as much discretion as he now has in section 201 cases. The President would retain unlimited discretion in cases involving "unreasonable" and "discriminatory" practices.

The worker rights provision still makes denial of certain worker rights (the right to organize and bargain collectively, a ban on forced labor, a minimum age for child labor) actionable under section 301. Cong. Pease has tried to improve this provision for us by taking into account a country's level of economic development in deciding whether lack of wage and hour laws and occupational safety and health standards will be actionable, and letting USTR ignore foreign labor rules if the country concerned is taking steps to afford such rights (in the whole country or in any zone). But this provision is still unacceptable as it stands.

Like H.R. 3, the Proposal makes targeting actionable under 301. Unlike H.R. 3, targeting is only actionable if the USTR determines that it is (or threatens to be) a significant burden or restriction on U.S. commerce -- a significant improvement. Action is mandatory unless the burden is only threatened; where mandatory, action need not be taken where contrary to the national economic interest (if this exception is invoked, an industry-labor panel must advise on measures to improve the industry's competitiveness). Action may consist of retaliation or a settlement agreement.

The Proposal eliminates H.R. 3's provisions on mandatory self-initiation of 301 cases. In the markup, the time limits were lengthened to 5 months for bilateral consultations and then 13 months in GATT cases for the panel process (a figure we believe we can live with).

#### Escape Clause Relief (Section 201)

The Proposal's provisions on section 201 show significant movement toward a bipartisan consensus that rejects industrial policy devices. H.R. 3 mandated submission of adjustment plans, drawn up by a tripartite government-industry-labor groups. The Proposal provides for voluntary (not mandatory) submission of an adjustment statement. The petitioner will have the opportunity to develop a plan jointly with other industry members, but tripartite groups have been eliminated. However, the government would be required to consult on these voluntary statements, a provision inconsistent with Administration positions.

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The Proposal largely adopts our proposal on fast track relief for perishable agricultural products, in place of the GATT-illegal version in H.R. 3. It also modifies the H.R. 3 proposal on provisional relief in section 201 cases to answer our legal objections. The Proposal adopts our language on treatment of recessionary conditions in the ITC's analysis of causation of serious injury.

Like H.R. 3, the Proposal transfers escape clause review authority from the President to USTR. The Proposal requires the ITC to find the form and level of relief that will be most effective to prevent or remedy the serious injury and facilitate efforts by the domestic industry to enhance its long-term competitiveness. USTR would be required to provide import relief unless it would threaten national security, or economic costs outweigh benefits; this would not substantially limit discretion to deny relief. (If the ITC's recommendation is rejected, USTR must explain the reasons in detail to Congress). These provisions are not acceptable.

Like H.R. 3, the Proposal requires annual follow-up reports by the ITC on adjustment and conditions of competition. Also, where changes in the relief are needed to prevent circumvention, reflect industry adjustment, or respond to exchange rate changes, the Proposal authorizes the ITC to recommend such changes to USTR.

The Proposal establishes an adjustment assistance trust fund as in H.R. 3, and newly provides for automatic certification of TAA petitions by workers and firms in an industry found to be seriously injured, for petitions filed within 3 years of the ITC determination.

#### Antidumping/CVD Changes

The Proposal has adopted most of the Administration's antidumping/CVD proposals, and has reduced some of our problems. However, it leaves out at least one of our proposals (indirect tax pass through), and major problem provisions remain that would unquestionably violate our international obligations.

The Proposal has dropped H.R. 3's provision on natural resource subsidies, substituting a generic fix that makes countervailable any benefit that has the effect of aiding an industry (such as roads or irrigation). It also pushes for use of external benchmarks (i.e., U.S. practice) in judging whether a country's internal practices are subsidies. These are unacceptable.

Another major problem is the private right of action for dumping. The Proposal drops H.R. 3's provision on a private right of action, but substitutes a Semiconductor Industry Association proposal that is improved but still unacceptable. It provides for

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monitoring of imports from companies that are found multiple times to be dumping, and self-initiation of antidumping cases by Commerce. However, 3 antidumping findings against the same company would establish a rebuttable presumption of intent to injure a U.S. industry, in suits for (single) damages under the 1916 Antidumping Act. This rule discriminates against imports and violates the GATT.

The third major problem is diversionary dumping. H.R. 3 proposed to attack diversionary input dumping (imports incorporating dumped inputs) by having Commerce arbitrarily adjust the dumping margin on the downstream product to reflect the advantage conferred by purchase of the dumped input. The Proposal would still impose antidumping duties on finished goods that contain dumped inputs, although only major inputs would be eligible for scrutiny, and more flexibility is provided for adjustments. However, this proposal still clearly violates the GATT.

The Proposal responds to our concerns by providing discretion for the ITC to eliminate cases against negligible imports from marginal supplier countries by excluding these countries from cumulation of injury. It also replaces a special-interest provision in H.R. 3 for the cement industry with a neutral generic provision, and drops targeting as a factor for determining threat of material injury.

### Intellectual Property Rights

There has been no change in proposals for section 337. The Downey amendment of last year (MPAA's proposal for a sectoral reciprocity program) has been substantially modified to avoid creation of a separate, sector-specific trade remedy for intellectual property rights (IPR) with mandatory retaliation. Instead, IPR problems are dealt with under section 301 and retaliation remains discretionary.

### Functions of the USTR

H.R. 3 proposed codification of the provisions of Reorganization Plan No. 3 of 1979 on USTR responsibilities. The Proposal's provision on this point is essentially unchanged. It adds a sense of Congress that the USTR go to economic summit meetings, and that the USTR be the senior representative on any body the President establishes to advise him on economic policies in which trade matters predominate. H.R. 3 prescribed the membership of the TPC; so does the Proposal, and adds to the TPC's duties.

The Proposal keeps H.R. 3's proposal (which we did not oppose) requiring an annual trade policy agenda statement to the trade committees. On the other hand, the Proposal drops H.R. 3's proposal (which we strongly opposed) for a fair trade advocate inside USTR to represent petitioners before Commerce and the ITC.

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In addition, individual provisions elsewhere in H.R. 3 transfer to USTR the President's authority to make unfairness determinations in section 301 cases, to review ITC determinations in section 201 and section 337 cases, to make GSP decisions and to act in section 406 cases (market disruption by NME imports). The Proposal maintains these transfers of authority.

H.R. 3 proposed to require re-confirmation of the ITC Chairman and Vice-Chairman by the Senate; the proposal drops this provision, targeted at Chairman Liebelier.

#### Miscellaneous Trade Law Provisions/Tariffs

H.R. 3 proposed amending section 232 to shorten the deadline for the Commerce Department investigation from the present 1 year to 90 days, and to require Presidential decision in 30 days and action in another 15. The Proposal relaxes these deadlines to 9 months for Commerce, 90 days for the President and 15 days to proclaim action.

H.R. 3 required that downstream steel products be counted against the export quota of the country where the steel in them was melted and poured. This would have violated all of our bilateral steel VRAs. The Proposal keeps the provision but makes it non-mandatory.

"Scofflaw penalties" in H.R. 3 provided that importers convicted three times of customs fraud or gross negligence would be barred from importing any product for 7 years. In response to retail industry concerns, this has been cut back to cover civil or criminal customs fraud only.

New items in the Proposal include authorization of product-by-product withdrawal of CBI treatment (for instance, in case of broadcast piracy); a requirement that the ITC perform annual studies on the conditions of competition in key sectors of the U.S. economy and their implications for national economic security (to be factored into USTR's annual Trade Policy Agenda); and a requirement that the President submit a competitiveness impact statement to the trade committees of Congress in advance of any relevant regulation, executive order, agreement or proposed legislation.

There are no new proposals otherwise among the miscellaneous trade law and tariff provisions. Last year's sense-of-Congress provision on U.S. semiconductor negotiations has been dropped (overtaken by events). The Proposal liberalizes imports of Soviet furskins and implements the Nairobi Protocol and the International Coffee Agreement, as the Administration has requested.

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**Telecommunications**

The Proposal retains H.R. 3's telecommunications title, which incorporates Cong. Matsui's bill. It provides that within 6 months after enactment, USTR must identify and analyze foreign acts, policies or practices that deny fully competitive market opportunities (FCMO) to the telecommunications products and services of U.S. firms. USTR must set specific objectives for each country to reach FCMO, and negotiate with all countries that deny FCMO. If agreement cannot be reached within 18 months after enactment, the President must take action to achieve the USTR-set objectives. USTR must conduct annual reviews of past telecommunications agreements. We have objected strongly to this proposal all along, and we still object, both because we fundamentally object to sectoral reciprocity and because we object to mandatory retaliation.

3/13/87

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27 February 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING

Economic Policy Council

DATE

Friday, 6 March 1987

TIME

1400

PLACE

Roosevelt Room

CHAIRMAN BY

Baker

ATTENDEE(S) (probable)

NIO/Econ

SUBJECT/AGENDA

Farm Bill, Steel, Minimum Wage

PAPERS EXPECTED

By COB 4 March

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*no one  
attended*

SECRET

**SECRET**

3 February 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING

Economic Policy Council

DATE

~~Monday, 9 February 1987~~  
*Friday, 13*

TIME

1100

PLACE

Roosevelt Room

CHAIRMAN BY

Baker

ATTENDEE(S) (probable)

NIO/Econ

SUBJECT/AGENDA

Airbus

*Deane Hoffman attended*

PAPERS EXPECTED

By COB 6 Feb

INFO RECEIVED

Per Cabinet Affairs memo dated 30 Jan 87

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Friday, 13 February***SECRET**

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Remarks

Executive Secretary

12 Feb 87

Date

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THE WHITE HOUSE

WASHINGTON

February 12, 1987

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER *EM*

SUBJECT: Agenda and Paper for the February 13 Meeting

The agenda and paper for the February 13 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Roosevelt Room.

The single agenda item will be a discussion of the Airbus governments' attempt to win orders away from McDonnell Douglas. The TPRG has developed for the Council's consideration several short-term options for ensuring that Airbus' tactics do not undermine McDonnell Douglas' launch of the MD-11. The TPRG has also developed a longer-term approach to addressing the problem of ensuring equitable conditions in airframe manufacturing. A paper prepared by the TPRG is attached.

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**ECONOMIC POLICY COUNCIL**

**February 13, 1987**

**11:00 a.m.**

**Roosevelt Room**

**AGENDA**

- 1. Airbus**

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THE UNITED STATES TRADE REPRESENTATIVE  
WASHINGTON  
20508

February 11, 1987

## MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: THE TRADE POLICY REVIEW GROUP

SUBJECT: AIRBUS

### Issues:

Recent high-level consultations between the United States and Airbus governments have shown no willingness on the part of the latter to refrain from providing subsidized and other support for Airbus, particularly the launch of the new Airbus A330/340 aircraft programs. Moreover, since McDonnell Douglas announced the launch of the MD-11 on December 29 with twelve committed airlines, Airbus Industrie has undertaken an aggressive campaign to win orders away from the announced customers for the MD-11 by offering incentives and deep price cuts on the competing A-340. This activity, should it succeed in reversing key customers, immediately threatens to cancel the MD-11 program.

In view of the above, the Economic Policy Council must address two interrelated issues:

1. What should be our long-term strategy to respond to the European intention to continue to provide subsidies and other support to Airbus and its consortium partners?
2. What steps should the U.S.G. take over the short run to ensure that Airbus' tactics and their government practices do not undermine the MD-11 launch?

### Background:

#### Report On Recent USG Consultations With Airbus Governments

Deputy USTR Smith and Undersecretary of Commerce Smart met with high-level officials of France, the Federal Republic of Germany, and the United Kingdom from February 2-4 to express U.S. concern about continued heavy subsidization of Airbus.

The three governments indicated that they are politically committed to having a "successful" European airframe industry, intend to continue to support it, and almost assuredly will support the A330/340 programs, if Airbus can sign up at least five launch customers. (The Commerce Department estimates that the three governments will provide \$2-\$2.5 billion in launch assistance for the proposed A330/340 aircraft programs.)

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The USG public challenge to the proposed new programs is being used to coalesce intra-European support for Airbus, although some Airbus government officials have private doubts about the commercial viability of the A330/A340 program and are concerned that the proposed subsidies may eventually invite counteractions by the USG.

The only solution suggested by the Europeans to avoid the possibility of increased conflict and government outlays over this issue was either increased cooperation between Airbus and McDonnell Douglas or a market sharing arrangement that would allow Airbus to increase its current 17 percent world market share to 30 percent with USG acquiescence.

#### The MD-11 Launch

McDonnell Douglas Corporation (MDC) in December 1986 launched the MD-11 aircraft with 52 orders and 40 options from 12 customers. By the end of 1986, MDC had booked 20 of the orders as firm. The remainder are covered by short-term letters of intent. The estimated market for A340/MD-11 aircraft is too small to support both competitors profitably. A successful MD-11 is crucial to MDC's long-term ability to continue producing large transport aircraft.

Airbus Industrie is making a major effort to reverse the announced decision of the MD-11 launch customers in favor of the A340, particularly Alitalia, Swiss Air, SAS, British Caledonia and Thai International. Airbus Industrie offers are reported to include: Price discounts that undercut the MD-11 launch price by 20 percent; offers of either low cost or free interim lift aircraft until the A340 aircraft is delivered to bridge at least a two year MD-11 delivery advantage; and reported payoffs to individuals in at least one instance.

Airbus governments contend that Airbus' attempts to woo away announced launch customers is normal industry practice, a fact vigorously disputed by MDC. It is clear, however, that Airbus' ability to offer deep price discounts is because ultimately the risk of loss falls on European governments and not Airbus Industrie. It should be remembered that over its 17 year life, Airbus Industries has not earned any profit and has benefitted from an estimated \$5-10 billion in direct program subsidies.

For MDC, loss of key launch customers could cause the cancellation of the MD-11 program. At a minimum, it appears that MDC will have to offer new price concessions to hold current launch customers, which will greatly reduce the financial prospects for the program.

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### Airbus' Long Term Objectives: Implications for U.S. Airframe Industry

Airbus and its government supporters are committed to the following objectives: 1) to firmly establish a European civil aircraft industry that can capture at least 30 percent of the world market, equivalent to the share of European aircraft purchases from the world; 2) to break the U.S. "monopoly" on large transport aircraft by producing a family of aircraft and thereby increase competition.

It appears that European governments are willing to do what is necessary in terms of financial and other support to enable Airbus to attain the above stated objectives. At a minimum, their activity will place extreme downward price pressures on U.S. manufacturers, threatening their long-term ability to generate a fair return on private equity. More significantly, it could force McDonnell Douglas to cease producing large transport aircraft altogether.

#### Options:

##### I. Long-term

The long-term objective of the U.S. government is to ensure equitable conditions of competition for U.S. airframe manufacturers. In order to achieve this, it is necessary to obtain Airbus government agreement to reduce and eliminate subsidies and other support for Airbus. U.S. government efforts in this regard should include action in the GATT and, if appropriate, additional actions as discussed below.

##### -GATT Action.

GATT action is possible on one of two tracks. The first track would be geared to consultations and negotiations leading, if successful, to a strengthening of existing rules in the GATT Aircraft Agreement. It is now clear that the Europeans interpret existing GATT rules as placing few constraints on them. The second track would be a dispute settlement proceeding based on existing rules.

The TPRG agrees that the U.S. government should immediately pursue the first track by asking for emergency consultations under Article 8.7 of the GATT Aircraft Agreement. The TPRG also requests authorization to institute GATT dispute settlement proceedings against Airbus government practices in the event that rapid progress is not made in a Track 1 exercise.

##### -Other Actions.

The TPRG believes that other actions to achieve our long-term objectives may also be necessary. Such actions might be taken either subsequent to, or concurrent with, any

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action underway in the GATT. To this end, the TPRG has directed a TPRG Task Force to study the following possible actions and to provide an assessment to the TPRG of the likely effectiveness of such actions in achieving our long-term objectives.

- Providing assistance in the future to U.S. aircraft companies in selected transactions. (Such assistance might take the form of official financing support, direct subsidies to U.S. companies, or the provision of U.S. government incentives to third countries whose airlines were purchasing large transport aircraft.);
- Self-initiating antidumping and/or countervailing duty cases against Airbus;
- Self-initiating a broad Section 301 case against Airbus government practices;
- Placing U.S. airlines on official notice that purchasing Airbus aircraft could make them liable for penalties imposed under U.S. trade laws; and
- Seeking trade legislation specifically directed at this issue. (For example, by providing for easier demonstration of threat of material injury for aircraft or other high technology companies that currently show profits or full order books.)

## II. Short-term

The short-term USG objective is to ensure that Airbus government or government-supported intervention does not undermine the MD-11 launch.

The TPRG has discussed the options set forth below but has reached no consensus on which of these options, if any, would be appropriate at this time. The TPRG does agree, however, that implementation of any of these options, if approved by the EPC, should be fully coordinated with McDonnell Douglas.

### Option 1: Apply senior-level political pressure.

The Secretaries of State, Treasury, and Commerce and the USTR would strongly bring U.S. concerns to Airbus partner governments' attention as well as urge appropriate governments of MD-11 purchaser airlines to honor existing letters of intent with McDonnell Douglas.

### Advantages:

- o Would put Europeans on notice that U.S. Cabinet strongly supports McDonnell Douglas on this matter.
- o Both Airbus and potential launch customer governments

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would have to weigh potential reactions by the USG against the benefits of reversing the MD-11 sales.

**Disadvantages:**

- o Would firm European political support for Airbus and increase risk of eventual trade conflagration.
- o May not be effective with governments of some airlines, particularly with potential European customers for the MD-11 (Swiss air and SAS)

**Option 2: Provide price subsidies to McDonnell Douglas to match Airbus price subsidies for launch customers.**

Under this option, the USG would neutralize Airbus' price discounting tactics for McDonnell Douglas' launch customers by providing direct subsidies to McDonnell Douglas to match Airbus' price offers.

**Advantages:**

- o Would respond in kind to Airbus government action and threaten Europeans with a no-win drain on government resources in this launch competition.
- o Would attack Airbus government subsidies directly in the commercial arena for the first time.

**Disadvantages:**

- o Price-matching subsidies could be expensive. For example, to respond to Airbus 20 percent price cut incentive package to European launch customers (i.e. Alitalia, Swissair, SAS) could cost as much as \$300 million. (e.g. \$10 m per aircraft for 30 aircraft)
- o Could set precedent for future aircraft competitions and for other industries facing unfair or allegedly unfair international competition.
- o Such subsidies would require special Congressional appropriations and compete with other national spending priorities.

**Option 3: Self-initiate a Section 301 investigation against unfair Airbus government practices used in the MD-11 case.**

Under this option, such investigation would be limited specifically to those practices bearing on Airbus' efforts to undermine the MD-11 launch. Self-initiation would be contingent, however, on McDonnell Douglas' ability to produce enough concrete evidence that unfair practices were used and that McDonnell Douglas had been harmed so as to warrant a formal 301 investigation.

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**Advantages:**

- o Signals firmness of purpose by USG and that we will follow through on our threat.

**Disadvantages:**

- o Self-initiation of 301 case puts burden of proof on USG, and presumes that President will find affirmatively and take retaliatory action.
- o It would be difficult to specify retaliatory trade actions on aircraft which, if mirrored in European retaliatory reactions, would not be on net disadvantageous to the entire U.S. aerospace industry.

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23 Jan 87

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

## TYPE OF MEETING

ECONOMIC POLICY COUNCIL

## DATE

Tues. 27 Jan 87  
~~MONDAY, 26 Jan 87~~

## TIME

1100

## PLACE

Roosevelt Room

## CHAired BY

## ATTENDEE(S) (probable)

NIO/ECON

## SUBJECT/AGENDA

Canadian Free Trade Arrangements

## PAPERS EXPECTED

None

## INFO RECEIVED

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27 JAN 1987

*Deane H. Hoffman  
attended***SECRET**

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING

Economic Policy Council

DATE \_\_\_\_\_

Friday, 9 January 1987

TIME

1430

PLACE

Roosevelt Room

CHAired BY

Baker

ATTENDEE(S) (probable)

NIO/Econ

**SUBJECT/AGENDA**

## Trade Legislation

## PAPERS EXPECTED

N/A

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Dear Hollis  
attending

**SECRET**

**SECRET**

6 January 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

## TYPE OF MEETING

Economic Policy Council

## DATE

Wednesday, 7 January 1987

## TIME

1400

## PLACE

Roosevelt Room

## CHAired BY

Baker

## ATTENDEE(S) (probable)

NIO/Econ

## SUBJECT/AGENDA

Trade Legislation

## PAPERS EXPECTED

N/A

## INFO RECEIVED

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